WORRY AT THE WORLD'S BANKS

The world's financial system is facing its greatest test of strength in decades. And even though the plunge in interest rates will bring relief to some borrowers, scores of others, from corporations to governments, are becoming delinquent debtors overnight, threatening the profitability of individual banks and the liquidity of the entire financial system. Already battered by problems ranging from Penn Square to Poland, creditors are rushing to save Mexico by rescheduling debt and extending fresh credit on a scale never before attempted. "The one thing we know is that things are going to get worse before they get better," says Alexandre Lamfalussy, chief economist and assistant manager for the Bank of International Settlements in Basel, Switzerland. Bankers are bracing themselves for a rescheduling of Argentina's $24.8 billion bank debt, and Peru is likely to go to international bankers for a second rescheduling of $4.4 billion in bank debt.

Mexico—of strategic importance to the U.S. and because its oil ranks it as a major economic power despite its recent fall from financial grace—will be permitted to delay principal payments on a portion of its debt. And a financial package combining bridge loans and new money will be offered by central banks, the International Monetary Fund, the U.S. government, and commercial banks. The total value of the package could reach $10 billion. "Mexico is not Poland," stresses one U.S. Treasury Dept. official. "They face an illiquidity problem, but they will be able to resume payment on their debt."

Some 115 senior executives from international banks heard out the country's Finance Secretary Jesus Silva Herzog, at a hastily called meeting in New York on Aug. 20, and a 14-bank steering committee was quickly formed to set the terms of a new bank loan. But however swift the accommodation of that troubled economy's needs, it will not mark the end of bankers' woes.

Bankers are worried not only about the actual loan losses banks will suffer, but also about market perceptions of bank problems. The problems are "considered by most market participants as systemic or endemic," says J. Paul Horne, European economist for Smith Barney Harris Upham Inc. The greatest threat to the financial system, bankers concede, is from depositors and institutional investors who might suddenly decide that yanking money out of a number of banks would be prudent—and for them, it might be, but it could precipitate a widespread liquidity crisis. "The worst thing that could happen is for major institutions to find their funding opportunities severely constrained by a market so obsessed by a flight to quality that it refuses to lend to these institutions," warns one U.S. bank economist. "We're not in that case yet, but there's a potential confidence problem. There'll be no systemic problem as long as the flight to quality doesn't get out of hand."

Problem loans pile up

Growth instead of judgment

OPEC's surpluses disappear

So far, institutional runs have occurred only on a limited basis. A small Texas bank, Abilene National Bank, beset by rumors that its energy portfolio was troubled, suffered such a run following the failure of Penn Square Bank. The Federal Reserve, acting as lender of last resort, advanced money to the bank, but the institution was finally merged into a larger bank holding company in Texas. In Europe, where the collapse of Italy's Banco Ambrosiano sent shock waves through the financial system, creditors of the bank's Luxembourg subsidiary suddenly found themselves unprotected by central bank guarantees they had assumed were there all along.

Tiering the banks

These incidents have turned markets skittish, and a handful of corporations with spare cash are reportedly shunning bank certificates of deposit and commercial paper as investments. A genuine liquidity crisis necessitating speedy reaction by central bankers has not occurred, but several banks have been stung. Continental Illinois National Bank & Trust Co., caught in the Penn Square tangle with $1 billion in energy loans it had bought from the failed Oklahoma City bank, is paying a premium for purchased funds. And markets were shocked by the losses Chase Manhattan Bank had to swallow in the wake of Drysdale Government Securities Inc.'s failure to pay its debts. The aftertax cost to Chase of covering Drysdale's obligations to securities firms was $117 million, and it posted a $16.1 million loss as a result during the second quarter.

German banks, already badly exposed to problems in the East bloc and faltering domestic corporations such as AEG-Telefunken, recently found their Luxembourg subsidiaries straining to raise funds after the Ambrosiano failure.

Worldwide, a "tiering" of bank names is taking hold, with some banks paying more for borrowed money than others. And in an interbank market where 1,000 participants—up from nearly 200 a decade ago—borrow and lend funds on a short-term basis, even the rumor of trouble can shut a bank borrower out. Bankers concede they cannot be sure of their exposure in the interbank market because a single loan to one bank may go through a series of borrowers and foreign exchange conversions.

When Mexico's financial troubles exploded in mid-August, the markets were prepared to believe that major U.S. banks would lose millions on loans made south of the border. In this panicky atmosphere, rumors outran facts. At one point, the spread between three-month U.S. Treasury bills—deemed a safe investment—and commercial bank CDs widened to 300 basis points, or three percentage points, double what it had been days earlier. "The markets aren't necessarily adjusting appropriately or logically," says one bank economist.

The dramatic reversal in Mexico's fortunes strikingly demonstrates the chain of events that has transformed once-worthy borrowers into sickly debtors. Driven by the inflationary fervor of the late 1970s and brimming with deposits from OPEC, banks extended ever-increasing amounts to hungry corporate and

sovereign borrowers. Commodity prices spiraled, oil seemed as good as gold, real borrowing costs were negligible, and the dollar was weak. Borrowers were convinced they could pay loans back in cheaper dollars. "The banking system can't be divorced from the world economic system," says David F. Lomax, group economic advisor at National Westminster Bank in London. "The OPEC situation led to an aberration, a permissive attitude to borrowing. That couldn't go on forever, and that is what's happening. We're seeing the withdrawal symptoms."

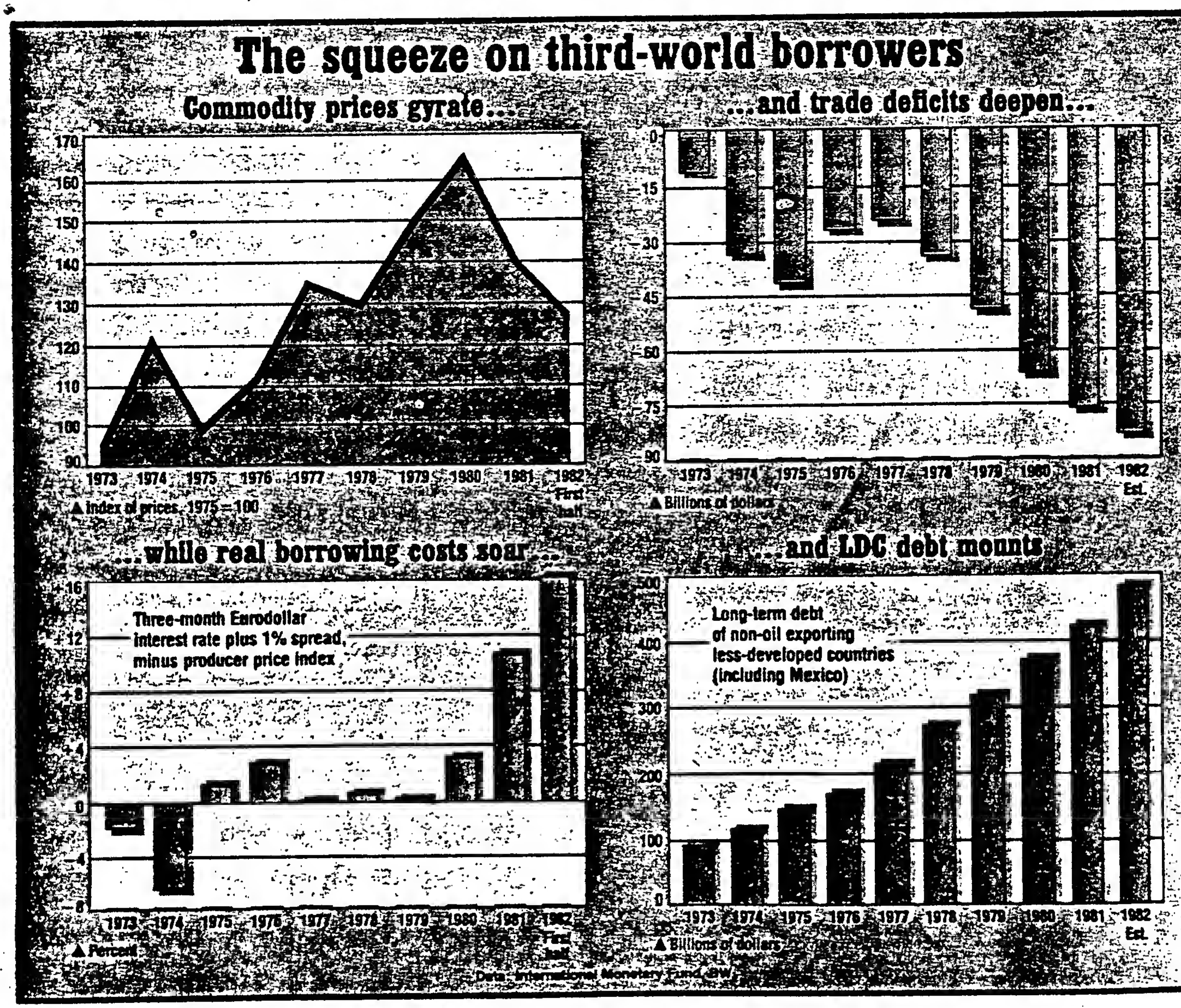
From 1973 to 1981, long-term debt of less developed countries (LDCs) surged from $97.3 billion to $425.2 billion (chart), an average annual growth rate of 20%. Debt owed by the East bloc alone soared from $7.9 billion to an estimated $80 billion during the same period. And although government and supranational agencies such as the IMF and the World Bank played a part in recycling surplus dollars from OPEC to LDCs, their share of the debt pie declined. By 1982 commercial banks in the West held $327 billion, or 65%, of total LDC and East Bloc debt, up from 45% a decade earlier.

But the world turned upside down for third-world borrowers when, in an effort to halt the inflationary spiral in the U. S. and strengthen the dollar overseas, the Federal Reserve System in October, 1979, began managing the money supply rather than targeting interest rates. Real interest rates—those adjusted for inflation—had averaged only 0.85% from 1973 to 1980, rocketed to 10.68% in 1981, and averaged 16.1% in the first half of this year.

Each percentage point rise in the London interbank offered rate—the rate to which most loans to governments are tied—translated into an annual increase in debt service of $350 million each for the largest government debtors, Mexico and Brazil.

While borrowing costs climbed, the price and volume of commodity exports fell, and global recession dampened demand for third world goods and services. The impact on growth rates was severe: The rise in Latin America's gross domestic product, for instance, fell from 5.8% in 1980 to 1.2% in 1981.

Worse yet, LDC borrowers were forced into borrowing short-term by banks that had soured on granting riskier medium- and long-term debt. The tendency became so widespread that by yearend 1981 fully 49% of Mexico's $57 billion in bank debt was coming due within one year. In 1982, Argentina must repay or refinance 47% of its bank debt, while South Korea, Chile, Venezuela, and the Philippines face similar pressures. Considered less risky than term debt, short-maturity loans are generally cheaper and easier for borrowers to obtain, since a wide variety of institutions—including credit unions, insurance companies, and investment firms—are willing to extend such credit. But these institutions are also the quickest to run at the first sign of trouble. "I worry about how everything now is so short," complains the



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executive vice-president of a major U. S. bank. "Everything in the whole damn world comes due between now and next Tuesday."

The high cost of cash and the clobbering of commodity prices have also hit the major oil producers. With the OPEC surplus projected to fall from about $60 billion in 1981 to near zero this year, several OPEC nations themselves will have to borrow in world credit markets. Their new presence could easily crowd out some LDC borrowers and possibly put upward pressure on interest rates. And while the decline in oil prices would be expected to benefit nonoil-producing developing countries, some fear that the relief will be minimal. A study by economist William R. Cline of the Institute for International Economics in Washington asserts that "for each $1 billion reduction in the OPEC surplus, the deficit of nonoil developing countries declines by only $140 million, or 14%."

Some bankers worry that the medicine used to bring the fever down—a heavy dose of monetary restraint—may have been too strong. "You get to the stage where the additional impact of monetarism gives you smaller and smaller returns in terms of reduction in inflation at a bigger and bigger cost in terms of the level of unemployment and the dislocation in the industrial and financial system," says Harry Taylor, president of Manufacturers Hanover Corp.

Corporate casualties

The turnaround in economic conditions worldwide has whipsawed corporations just as surely as it has devastated nation-states. Until recently, the after-inflation and after-tax benefits of short-term bank borrowing, especially in the U. S., encouraged companies to flock to the banks, rather than raise long-term debt at high fixed rates. By the time declining inflation had pushed real rates of interest to record levels, corporate borrowers were caught in a vicious circle. In order to pay off bank loans, they had to borrow still more money.

The consequences of this squeeze are now becoming apparent. Such corporate giants as Germany's AEG-Telefunken, Mexico's Grupo Industrial Alfa, and International Harvester in the U. S. are struggling under a mountain of debt and asking their bankers for relief. Numerous other smaller companies are throwing in the towel, filing for reorganization and protection from creditors under bankruptcy laws. Corporate bankruptcies and reschedulings promise to put a far deeper dent in bank earnings than do sovereign debt problems. "Compared with what the French steel industry owes us, Polish debt is a minor problem," says an official at a French bank.

International bankers leave the New York Fed after a hastily called meeting, where they listened to Mexico's finance secretary plead for debt relief and new cash.

Corporations, bankers point out, have a "bankruptcy option" that countries cannot afford. Says one U. S. bank economist: "The portfolio weighted toward foreign sovereign debt is far more secure than one weighted to private sector debt. A borrowing country cannot refuse to service its debt. It would be blackballed from the system."

Problem loans to corporations are largely responsible for the swelling of loan loss reserves and "nonperforming" loans at U. S. banks. And while lower rates will mitigate financial strains for some corporations, others will be unable to recover from months of poor sales and pitiful cash flow. Furthermore, corporate casualties lag behind recessions, and bankers expect problem loans to continue to climb in coming months.

Evaluating the quality of loan portfolios and determining the size of loss reserves needed to cover problem loans will be the "hardest, most complex, and challenging task" confronting the banking industry in coming months, says Thomas H. Asson, chairman of the banking group at Coopers & Lybrand. Management response to problem loans is "very judgmental," Asson says. "You can put 100 people in a room with 100 different portfolios, and they can come up with 100 different ways of dealing with the same credits."

U.S. banks with the most at risk in Mexico

	Billions of dollars
BankAmerica	$2.75
Citicorp	2.5
Chase Manhattan	1.75
Manufacturers Hanover	1.5
Chemical New York	1.1
J.P. Morgan	1.0
Bankers Trust New York	0.8
Continental Illinois	0.7
First Chicago	0.7
First Interstate Bancorp	0.7
Total	$13.5

Data: BW estimates. Includes loans to both public and private entities

This variability is ultimately reflected in bank earnings. Because banks are in the business of assuming credit risks, they constantly maintain a cushion, known as a loan loss reserve, to cover potential losses. Additions to the reserve are deducted from earnings, so they have a critical bottom-line effect. As of June 30, the aggregate reserve level for 35 major U. S. banking companies had surged to $6.1 billion, or 1.02% of total loans, according to Salomon Bros. Inc.

More nonperformers

Only a tiny portion of this reserve was allocated to cover possible losses on sovereign lending. Loans to countries have been viewed as "evergreen" because of continuous rollovers and government reluctance to take the "bankruptcy option." Regulators have looked the other way, but now they are considering a tougher stance (page 83) that would mandate reserve allocations against rescheduled sovereign debt. Even if a Mexican rescheduling is successfully accomplished, concedes one Texas banker, "anyone who thinks the risks aren't there for write-offs is kidding himself." The biggest risks, of course, still lie in the corporate sector, and portions of Grupo Alfa's $2.2 billion in bank debt are reportedly already being reserved against possible loss by some banks.

For those institutions with heavy exposure to Mexico (table), a rescheduling

agreement that postpones principal payments but keeps interest payments current will spare a huge addition to nonperforming loans. The reason is that nonperformers are loans on which interest payments are in arrears, usually by 60 days or more, loans that have been restructured with a lower interest rate, and foreclosed real estate.

Increases in the nonperforming list are the best indication of trouble spots in a bank's loan portfolio. As of midyear, these problem loans at the 35 bank holding companies that Salomon Bros. follows amounted to $14.7 billion. Bank stock specialists at Keefe, Bruyette & Woods Inc. find that the nonperforming loans for 24 top banking companies amounted to 2.58% of total loans and foreclosed real estate. While on the rise, this figure is nonetheless well below the record 4.9% logged by the banks a few years ago.

Unsold condominiums

Among the newest additions to the nonperforming lists at banks are energy and real estate loans. Inflationary expectations propelled banks to leap into these lending areas, but lower oil prices, moderating inflation, and high interest rates have rendered countless drilling projects and condominium developments uneconomical. Energy equipment manufacturers such as Nucorp Energy Inc. and TOS Industries Inc. have filed for protection from creditors under bankruptcy law. Continental Illinois, struggling under the weight of $1.3 billion in problem loans, is owed $188 million by these two companies alone. The bank has also reserved against, and put on its nonperforming list, a portion of the $1 billion in energy-related loans it purchased from Penn Square.

Crocker National Bank's nonperformers will rise $32.7 million as a result of the TOS bankruptcy filing. In a lending specialty where the ability to predict the future value of oil reserves is critical, too many bankers, says Philadelphia National Corp. President Richard S. Ravenscroft, "sure as hell weren't watching the downside."

In Florida and California, thousands of condominium units have gone unsold, and developers are in arrears to banks that financed the developments. In California, where 60% of all recent housing starts have been for multi-unit developments, there is an inventory overhang of some 50,000 new and unsold homes. San Francisco-based Bank of America is tracking 2,500 new units as "critical" and has already foreclosed on 550 units. BofA may try to unload 50 condo units in Southern California within the next 60 days by holding an auction.

Despite the real-estate problems,

The central bankers call for discipline

Despite the banking community's vigorous defense of its stability and past behavior, central bankers and regulators are talking tough. They contend that the banks waltzed blithely into certain loans, particularly foreign ones, on the assumption that some official body—either central banks acting as lenders of last resort or supranational agencies such as the IMF—would eventually bail them out. Several officials now say that the system is too fragile to have to rely on ad hoc emergency responses, such as the Mexican rescue package hastily stitched together by 11 central banks under the auspices of the Bank for International Settlements and the U.S. government. "There has been an underlying problem here of shoddy bank lending that has to be tackled; this has got to stop," declares a European central banker. "A bust at one of the banks may get them interested again in prudent lending around the world. If not, we simply will have to somehow curb lending activities."

IMF's de Larosière: Banks would have him go to market.

Special case? Some bankers concede that the Mexican package was a politically motivated life preserver that might not be cast so readily to a future borrower on the edge of default. Mexico has a 1,500-mi. border with the U.S., is the U.S.'s third-largest trading partner, and is seen by the Reagan Administration as a democratic bastion against rising communist insurgency in Latin America. "Would you have gotten the same response with Brazil?" asks a U.S. banker. "No." Adds another: "Once you have two or three major banks with 80% to 90% of their bank capital exposed, it's not only a national security problem but a question of solvency for the U.S. financial system."

In addition to contemplating the requirement that loan loss reserves be set aside to cover some portion of rescheduled sovereign loans, banking authorities are floating other ideas. So-called hidden reserves, or bad-debt provisions that allow some foreign banks to report profits even when they are losing money, will come under greater scrutiny. The Swiss and British are already moving in this direction.

Others argue that banks in countries such as Germany and Austria are going to have to retreat from the common practice of "privileged lending" to corporate basket cases such as AEG-Telefunken, which was effectively kept afloat since 1978 by loans from banks with an equity stake in the company. Furthermore, observers contend that the Ambrosiano fiasco, which triggered a $400 million default by the Milan bank's Luxembourg holding company, will prompt authorities to curb the often unregulated activities of offshore facilities and consortium banks.

An IMF safety net? To help bolster the international financial system, some advocate strengthening the IMF's role so that it might act as a lender of last resort to beleaguered third world central banks that need assistance in a liquidity crunch. Commercial bankers would like Managing Director Jacques de Larosière to have the IMF borrow in private markets—an option it has never exercised—to enable the fund to play a bigger part.

In June, IMF officials met with executives of about 30 major banks to explore the possibility of having banks lend funds to cash-starved countries in much the same way as the fund does—by granting credit in graduated steps that can be held back if the borrowing country fails to meet conditions for economic reform imposed by the IMF. Bankers are interested, but they say the idea of extending commercial bank "conditionality" has not yet been presented to the Mexicans because many technicalities need to be worked out.

All of these ideas are intended to help make the system more secure while simultaneously forcing the banks to acknowledge additional risk. "Until now, there has been a general perception that banks or their major borrowers would not be allowed to fail. Banks could even raise the probability of a bailout by concentrating their lending on one large borrower who could then not be allowed to fail," says Alexander K. Swoboda, director of monetary and banking studies at the Graduate Institute of International Studies in Geneva. "We are now restoring some risk to the system," but whether it will be enough is something "we do not know."

bankers insist that their difficulties are different and less severe than in 1975-76 following the collapse of real-estate investment trusts. Says Joseph J. Pinola, chairman of First Interstate Bancorp, which has two-thirds of its $876 million in nonperformers in real-estate-related loans: "I'd rather have nonperforming loans collateralized by California real estate than some of the bad loans of Eastern banks."

The fallout from lending for real-estate ventures that have turned sour is not limited to U.S. banks. Canadian banks lent heavily to developers active in the U.S., and some of those developers are now in serious trouble. Vancouver-based Daon Development Corp. recently suspended interest payments on its debentures and is furiously trying to get bankers to reschedule $1.9 billion in debt. And Canadian banks face myriad problems domestically, where nonperforming loans, at $5 billion, are already four times greater than last year. Besides real estate, the trouble spots include the energy, mining, forestry, and fishing industries.

Eyeballing new customers

Britain's Barclays Bank suffered a second-quarter drop in earnings because of loans made by its U.S. operation to troubled corporations here. Dresdner Bank and other German banks are owed $1.6 billion by AEG-Telefunken and hold nearly 60% of the insolvent company's stock. And Belgium's third-largest bank, Kredietbank, is owed $210 million by a Saudi Arabian money exchange operation that went bust a month ago.

European banks have been forced to ante up embarrassingly large reserves to provide a cushion against losses. Around the world, major banks have been reporting lower earnings, and an international investment community worried about the possibility of large write-offs is chipping away at bank stock values. Declining interest rates and the chance for banks to profit from sizable lending spreads over the near term may offset loan losses to some degree, but it is still an inauspicious time for banks to acquire much-needed capital through the sale of new equity.

Already there is talk of retrenchment and re-evaluation of lending practices, especially in those areas where banks have gotten caught. Texas banks, with long experience in energy lending and still relatively unscathed energy portfolios, nonetheless are scrutinizing prospective customers in the oil and gas industry more carefully. "We've told our loan officers they've got to watch the quality of receivables, debt levels, and follow the credits more closely," says one executive at a major Texas bank.

Lawrence Barns

Citicorp's Theobald: "No statistical evidence" that the system is in crisis.

On the international lending side, bankers concede that they have not paid sufficient heed to country-risk analysts who warned of heavy concentrations in certain areas. Now bankers, especially in the U.S., are looking toward what they hope will be greener pastures. For instance, lending spreads on local currency loans to prosperous Asian corporations can be especially lucrative and consistently reward international bankers with profits exceeding the paltry returns they can earn by buying a piece of a sovereign debt syndication.

For all their difficulties, though, bankers insist that the international financial system is resilient and that a major crisis will be averted, provided public confidence is sustained. "The market is reacting as though these are the last signals before collapse," contends Bank of America Executive Vice-President Richard Puz. "The news is not good, but the banks are strong."

With their bankruptcy option, it's companies—more than countries—that vex the banks

Indeed, Citicorp Vice-Chairman Thomas C. Theobald points out that while Citicorp's assets have grown at a compound annual rate of 5% during the past 2½ years, its international loans have expanded at only a 1% rate. The bank holding company's equity capital has grown at a 9.3% rate in the same period. Meanwhile, Citicorp's actual losses on commercial loans outstanding worldwide were a modest $52 million during the first half of the year, or 0.18% of its average commercial loans outstanding.

Says Theobald of Mexico's current difficulties: "It's not a near-crisis point of unprecedented dimensions that's been visited on the financial system. There isn't any statistical evidence to say we're in a period of more pressure and more strain than at any other time."

Theobald is not alone. Manufacturers Hanover's Taylor contends that the recent spate of reschedulings has not damaged bank earnings but could improve them. "These countries, by and large, have been able to cope with meeting their interest payments," Taylor says, adding: "In fact, to the extent to which these events have broadened spreads, they're going to have a beneficial effect upon bank earnings."

How many skeletons?

Bankers point out that individual banks fail every year and that while many people thought the failure of West Germany's Herstatt Bank in 1974 was a catastrophe, the system did not collapse. "There are hundreds of thousands of decisionmakers acting as lenders, depositors, and borrowers," says Theobald. "No single event transmits itself to the marketplace. Mexico is not going to disappear, just like California is not going to disappear." The safeguards, Theobald and others contend, lie in the very diversity of the system.

Bankers also assert that measuring whether a borrower can repay all of the principal owed is an unfair way of judging the borrower's economic state or, for that matter, the bank's prudence in granting the loan in the first place. They note that such worthy borrowers as the U.S. government and American Telephone & Telegraph Co. are not expected ever to repay their entire debt, yet lenders continue to extend money to them.

Whatever strains the system is suffering, the biggest comfort to bankers and borrowers alike is the plunge in interest rates. Only if lower rates are sustained will the debt-service load on sovereign and corporate borrowers lighten, world economies recover, and LDC exports revive. Meanwhile bankers will have to suffer the suspenseful and wrenching experience of rescheduling debts, foreclosing on properties, and swallowing losses of both money and pride. While many bankers believe relief is in sight, observers are not so sanguine. Having seen a host of problems, both expected and unexpected, hit the banks recently, they wonder, as Horne of Smith Barney does: "How many live skeletons are there in the cupboard?" ■